ISSN 2816-8070

RESEARCH ARTICLE

Effect of Debt Suspension on the Financials of Banks: Evidence from India

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Abstract

To curb the negative effect of recent disruptions, the government of India has declared a nationwide lockdown strategy where only essential work is carried out. This bears a severe financial toll laterally with the health disaster. Several individuals have lost their jobs and are struggling to pay off their monthly loan installments. This called for the need for a moratorium on credit. The present paper highlights the impact of a debt moratorium on Indian commercial banks because of the pandemic. It gives a brief commentary on the financial health of banks affected by the stated strategy. A broad-based exploration of the database associated to a debt moratorium on commercial banks during the pandemic in India has been undertaken. Further, a short review has been undertaken on the extracted data through research papers, articles, and reports. The result revealed that though the banks will be benefited from the increased EMI on loans because of the moratorium only if people can repay, that seems highly unlikely due to the crisis. It will further damage the asset quality, and capital requirements and deteriorate the bank's profitability in the long run.

Key Words: *Moratorium; COVID-19; Banks; EMI; NPA; Credit crunch*

Jel Codes: *E52, E51, E58, N1, N2*

1. Introduction

The significant humanitarian repercussion of the coronavirus crisis bears with it, the unparalleled shockwave to the economy. In India, this financial emergency has been unsettling to a great magnitude. India's advancement in the final quarter of the monetary year 2020 went down to 3.1% as indicated by the Ministry of Statistics and crashed down to negative 23.9 in the first quarter of the financial year 2020-21 [1]. The Chief Economic Adviser to the Government of India said that this dewdrop is largely due to the coronavirus pandemic impact. Eminently India had additionally been seeing a pre-pandemic stoppage, and as per the World Bank, the current pandemic has "amplified prior dangers to India's economic viewpoint" [2].

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***Received Date**: April 07, 2025, **Accepted Date**: May 28, 2025, **Published Date**: June 03, 2025*

***Citation:** Raj M, Srivastava A. Effect of Debt Suspension on The Financials of Banks: Evidence from India. Int J Bank Fin Ins Tech. 2025;3(1):79-91.*

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This has been found to be disastrous in the case of India and India's growth for the last quarter of the fiscal year 2020 was at 3.1% as per the Ministry of Statistics and crashed to negative 23.9% for the first quarter of the fiscal year 2020-21 [1]. The Chief Economic Advisor to the Government of India had stated that this dewdrop has received best with respect to the coronary virus-soaked atmosphere. Notably India had also been witnessing a pre-pandemic standstill, and in the case of the World Bank, this ongoing pandemic has "multiplied India's economic outlook negative scenario".

The Government of India stated an assortment of measures to switch the circumstance, from food safety and additional reserves for health insurance and the states, to division incentives and tax time expansions. The debt moratorium is likewise one of the measures recommended by the Reserve Bank of India (RBI) that may have the option to give some transitory help to now and could likewise play a hand in changing the credit scene of the banking sector [3]. Debt forbearance policies, which let borrowers put off loan payments, are a common way to lessen the impact of economic downturns on the credit market. They have been adopted to a record-breaking degree in recent crises. In reaction to the Covid-19 crisis, more than 80 nations adopted debt moratoria for both individuals and businesses. Over this time, financial institutions in the U.S. alone gave more than 60 million debtors more than $2 trillion in debt forbearance. However, it is unclear how these repayment delays affect borrowers' actions and the general discipline of the lending market.

The analysis takes use of an exceptional regulatory environment produced by the significant debt relief measures implemented in response to the Covid-19 outbreak and has concentrated on India because it is one of the largest markets for consumer credit in the world. India had its first significant increase in illnesses in March 2020, and on March 25, 2020, the Indian government imposed its first statewide lockdown. Shortly after it was revealed, the lockdown seriously impacted the nation's economy. Similar to regulators in many other nations, the Reserve Bank of India launched an emergency provision package that includes a range of monetary and financial policy procedures targeted at preventing widespread financial distress in order to lessen these economic repercussions of the pandemic. The package contained a first debt moratorium, which gave bank and non-bank lenders the green light to defer payments on consumer and small company loans from March 1 through May 31, 2020. The package also included a significant amount of debt forbearance. The moratorium finally covered 40% of all outstanding loans in India and was extended for an additional three months to August 31, 2020.

1.1. Background and literature review

The word moratorium denotes the suspension of reimbursement of debt or interest for a particular timeframe [4]. A moratorium period is a period during a term loan when the borrower isn't committed to making an installment. It is a holding-up period before the borrower begins making fixed regularly scheduled installments. For instance, educational advances are reimbursed after an undergrad student, graduates and find a new line of work. The time between when the student got the advance to pay his school educational cost and expenses and when he graduated and found a new line of work and needed to begin making fixed month-to-month credit installments is a moratorium period. The moratorium infuses stability and provides structure in which the clients can settle on and progress the suitable strategy [5].

The study of the effects of debt relief on financially troubled borrowers has concentrated on the effects of debt reductions that happen through restructuring and loan modification or consumer bankruptcy. The main problem with debt forgiveness alleviation measures is that they might create moral hazard by altering borrower expectations regarding the execution of debt contracts and the long-term effects of non-repayment. Giné and Kanz found that a significant debt forgiveness programme in India caused widespread moral hazard, which unintentionally led to a reallocation of resources away from the borrowers covered under the program.

Since the borrowers may confront an absence of liquidity during the universal lockdown to stifle the spread of COVID-19, the RBI on March 27, 2020 permitted fiscal organizations and banks to offer a three-month (90 days) moratorium on term advances and credit card bills to facilitate the circumstance and maintain a strategic distance from a monetarist emergency. And afterward expanded it further till August 31, 2020, and at present expanded it for two years [6]. The RBI has allowed banks and different moneylenders to structure this delay which incorporates a wide range of advances including individual loans and credit card dues. The delay can't be viewed as a waiver and is just a relief, as it is payable sometime in the future. RBI has declared that all term advances, including rural, retail, crop term credits, and advances under pool buys are qualified for profit with the advantage of the moratorium period. The majority of the literature focuses on the causes of repayment default and delinquency. Upcoming research in the area of bank performance has acknowledged short-term liquidity limitations and adverse life measures as the primary reasons behind household non-repayment and bankruptcy filings, despite prior studies which highlight the strategic motives in repayment decisions as a major player. These findings suggest that temporary repayment deferments could help households maintain stable consumption, prevent unnecessary defaults, and serve as both a socially optimal and lender-preferred debt relief measure, especially when financial stocks are temporary. Supporting this perspective, Aydin (2021) examines various debt relief models in a randomized experiment, revealing that forbearance effectively mitigates late-cycle defaults among liquidity-constrained borrowers. Similarly, Barboni and Agarwal (2021) and Battaglia, Gulesci, and Madestam (2021) explore micro financial institutional contracts incorporating repayment flexibility, demonstrating that deferred payments enhance business outcomes by providing financial stability during periods of cash shortages.

We contribute to this field of study by examining how the advantages of temporary forbearance stack up against potential moral hazard expenses that can result from shifting borrower expectations.

Though the government tried to cater to the momentarily economic shock yet it should find a permanent solution as this temporary endeavor would probably hurt Indian banks' accounting reports and financial performance in coming years. Banks are yet to feel the impacts of India's lockdown strategy to contain the pandemic, with the seriousness reliant on to the pace of financial recuperation. The nation began relaxing lockdowns in numerous states in June 2020, which prompted economic activity, however, the speeding up of new COVID-19 cases undermines the resumption of regular business activities, triggering interruptions in commercial business, supply chains, and dwindling individual earning. According to the Centre of Monitoring the Indian Economy, the labor participation rate for the August week stood at 40.62% and the overall unemployment rate touched a nine-week high at 9.1%, hurting the borrower’s repayment capacity [7]. Moreover, India’s GDP emaciation recorded the worst fall in history, highlighting the financial instability in the country. The given Figure 1 and 2 shows the current unemployment rate and GDP in India of the present state.

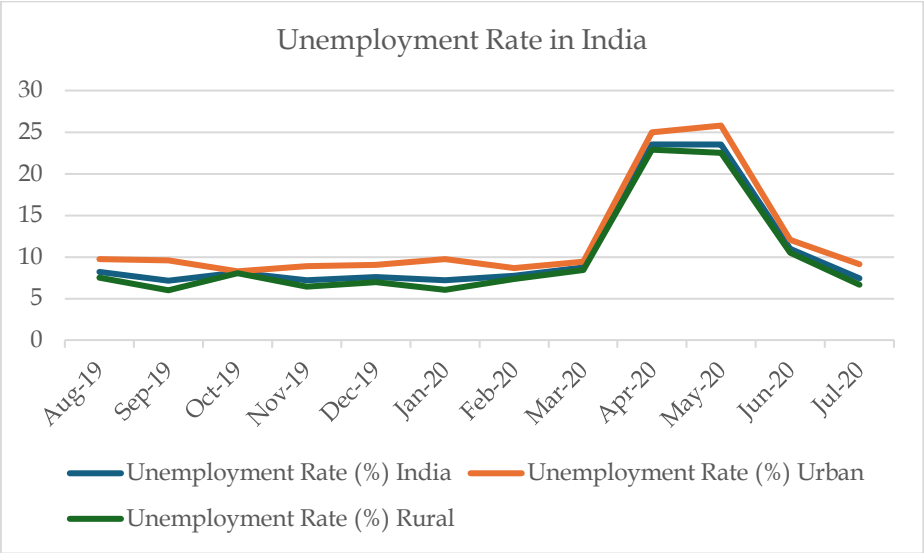

Figure 1: *Unemployment in India. Data is taken from CMIE- Centre for Monitoring the Indian Economy.*

Source: *https://unemploymentinindia.cmie.com/*

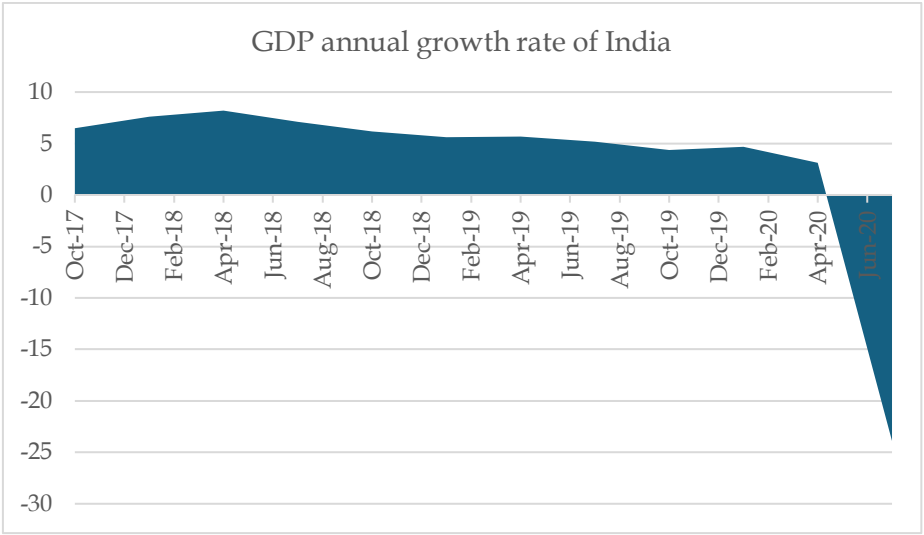

Figure 2: *The annual growth rate of India, GDP. Data is taken from- the Ministry of Statistics and Programme Implementation (MOSPI).*

Source: http://www.mospi.gov.in/

Banks should announce numerous loans as non-performing in their subsequent second and third quarter of the fiscal year (2020-21) results, or else they will miss the minimum capital prerequisite. Fitch Ratings evaluate that under a moderate stress situation; PSU banks will require at any rate $15 billion to meet Tier-1 standards. This implies the banks will require quick re-capitalization. The moratorium will prevent economies from tumbling off the cliff in the short term, yet if permanent solutions are impending, then there would be financial devastation in the future [8]. The loan moratorium as proposed by the RBI and in this way executed by different lenders across the nation might offer the option to give some brief help at present however could likewise have a hand in altering the credit framework of the banking sector.

The purpose of this study is to thoroughly inspect the prevailing financial health of the Indian commercial banks which is influenced by the moratorium on debt strategy opted by the government. This research paper underlines the factors in the banking sector affected by the moratorium during this pandemic time. These include the deterioration in asset quality, liquidity pressure, low capital adequacy, and lower net interest margins. The aim is to explore the harm a bank could face due to this elongated delay and economic slowdown.

2. Materials and Methodology

This research is done using the search instruments like Scopus, Google scholar, and Pro-Quest databases. The primary keywords were 'moratorium', and 'commercial banks' by the topic of this paper. The hunt and survey were restricted to reports by RBI and companies, newspaper articles, and notices from the Indian government. These articles date from March to September 2020. A narrative review is conducted and the major results are discussed appropriately.

3. Factors Affected by the Debt Moratorium

The significant source of revenue for banks is loan money, because of the moratorium the clients would postpone the EMI with interest, leading the bank to acquire a negative cash flow. To make up for this loss the banks are requested to re-access their working capital necessities on account of the interruptions of their income or lengthening of the working capital cycle [9]. To curb the financial effect of this deferment of loan installments and the interests of the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) slashed its key strategy rates to settle the monetary framework and tackle the financial aftermath from the progressing coronavirus lockdown. The RBI reduced the repo rate to 4 percent and the reverse repo rate to 3.35 percent. Though banks also cut their deposit rates on different tenures to deal with their balance sheets position. The RBI has permitted borrowers and banks to change the interest rates during this deferral time frame into a term credit which can be reimbursed by March 2021. It additionally made compulsory for Indian commercial banks to earmark 10% provision for all credits that are past due [10]. Because of moratorium, banking sector profitability will get effected. The loan-loss provisions will weaken asset quality, low net interest margins due to policy rates will hamper the bank's revenue, banks will face liquidity crisis due to the lack of installments and lastly the balance sheets will be disturbed giving way to impaired assets [11]. These could be seen in the fluctuating level of NPA, Capital Adequacy Ratio and financial statements of the bank. These factors are discussed in detail here:

3.1. Deterioration in asset quality

Bank credit development directed through principal bank hordes in the latter half of 2019-20. The bank's performance ratios have declined in the second half of the previous financial year and in the first quarter of this fiscal year 2020-21 the aggregate bank deposits and credit declined from 10.4 to 9.6 and 11.9 to 5.6 respectively [1]; the stance is held back by the moratorium's insinuations for loan classification. The decline in the macroeconomic and monetary condition has encroached the loan request, value of assets, capital ampleness, and incomes of Indian commercial banks that are subsidiary to the effect of COVID-19. The viewpoint stays obfuscated with significant vulnerability as the pandemic incurs significant damage.

Moody's experts said that the huge load of advances under moratorium demonstrates that banks' asset quality will decrease due to a high danger of the conceded credits turning out to bad loans when the postponement of loan repayment closes. This circumstance is credit-negative for banks since they would almost certainly need to ingest credit damages on the off chance that they need to restructure an enormous extent of their loan books because of bad loans or NPAs [12]. Figure 3 and 4 will demonstrate the level of rise in bad loans and the worsen asset quality in banks.

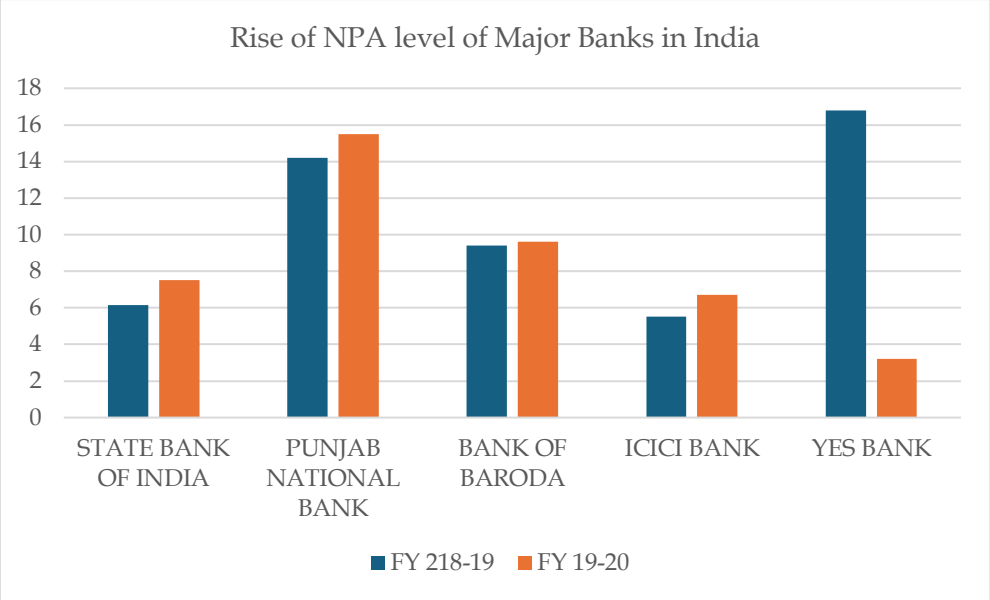

Figure 3: *Gross bad loans of major banks in India. Data source-capitaline database.*

Source: https://www.capitaline.com/

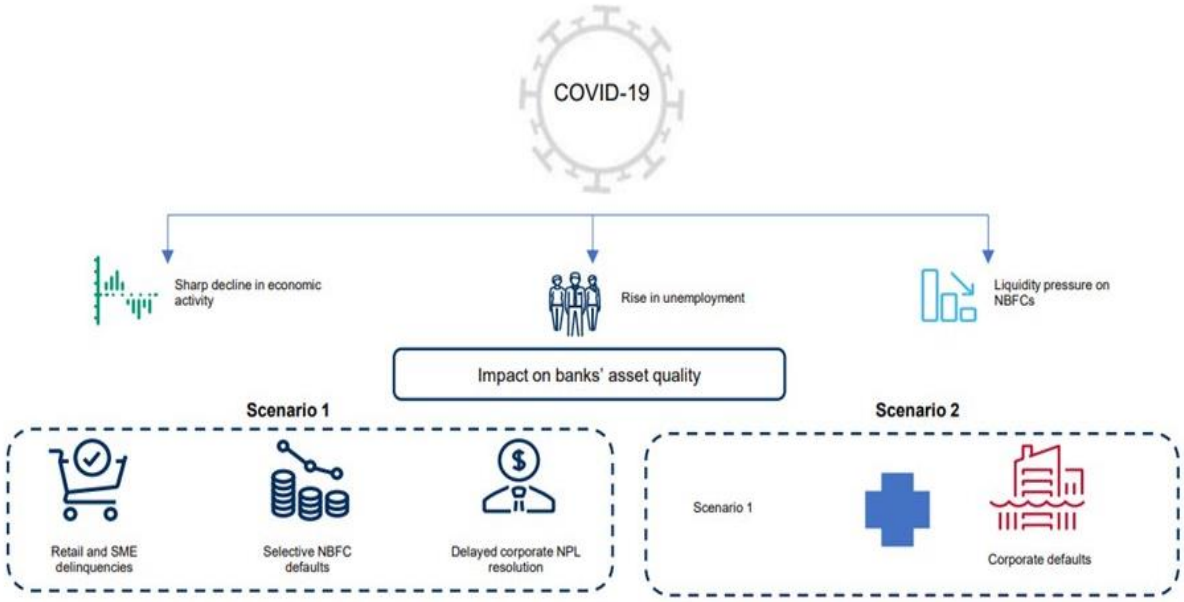

Figure 4: *Effect on asset quality of banks. Data source- Moody's Investors Service Database (MISO).*

Source: https://twitter.com/MoodysInvSvc/status/1297738428155600896/photo/1

Bank financial circumstances improve with a lower likelihood of loan defaults during economic expansions, but the opposite is true during recessions. Favorable circumstances during a period of expansion can result in an excessive increase in credit growth and make determining a borrower's creditworthiness simple because the likelihood of default on a loan is minimal. Consequently, because loan loss provisions are typically retrospective in nature, they also decrease. As a result, risk and financial imbalances accumulate during the upswing, increasing the possibility that the economy would contract in the future. On the other hand, loan loss provisioning increases during a recession when credit growth is low and loan defaults are on the rise. During these times, the bank's capital is badly impacted since provisions must be made from its profits [13]. Due to the crisis going on and the current unemployment rate there are high chances that several borrowers would not be able to pay their EMI, thus leading to default loan accounts. In order to tackle this problem RBI made it mandate for the banks to make general provisions of not less than 10 per cent of the total outstanding of default accounts [14]. As per the estimations done by the director of Brickwork Ratings, the RBI's specification on extra provisioning prerequisites could escalate the complete provisioning of banks by Rs.35000 crore in the March - June 2020 period. This includes the Special Mention Accounts which are 4% of the total financial advances and have been given the credit moratorium. Such a huge hit on profitability will likewise damage the capital adequacy of banks [15].

According to the Financial Stability Report [16] of the 1st quarter of this financial year, the total non-performing asset and the actual non-performing asset (GNPA and NNPA) ratios of all commercial banks were 9.3 percent and 3.7 percent in September 2019, respectively. It has declined to 8.5 and 3.0 percent, respectively by the end of March 2020. This can be seen in Figure 5. This can be seen from the falling quarterly slippage ratios among other banks. The repercussion of this led to the provision coverage ratio (PCR) of banks upgrading to 65.4 percent in March 2020 from 61.6 percent in September 2019. The Non-Performing Asset (NPA) provisions of the banks have been slowing down since March 2019, shown in Figure 5. Hence higher loan provisions, the declining graph of NPA levels and will deteriorate the asset quality of the banks hence decreasing their profits.

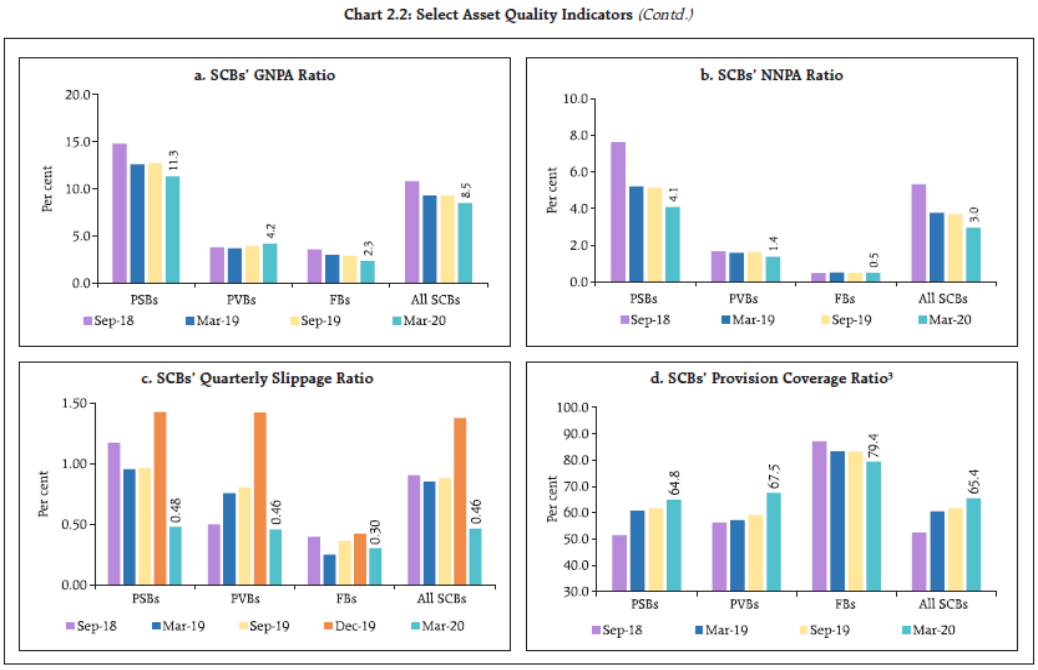

Figure 5: *The slowing NPA of banks. Data source- Financial stability report (July 2020), RBI.*

3.2. Liquidity pressure from the delayed collection

Economic exercises are easing back as millions practice social separating to stem the spread of coronavirus. Therefore, banks are at present encountering striking limitations on cash and working capital, including possible liquidity challenges. Banks are facing lower-income causing fewer cash flow, alongside of postponed receivables assortment, as necessities develop to step up payables to significant providers.

As the COVID-19 crunch will last longer than a couple of months, a moratorium on credits will progressively get indefensible. Except if the administration steps in and powers the moratorium on debts or loans straightforwardly to the client, banks themselves will start to struggle [17].

Given this deferral on client advance reimbursement, low assortments in the following months could drain the accessible cash collateral for a transaction. In any case, for some evaluated transactions, the installment structure changed to timely interest and ultimate principal. Under the restructured loan, principal payments are presently made on a pass-through base focused on loan assortments acknowledged in a given period. From a liquidity point of view, the restructured loans are stronger than any cash flow interruptions that result from decreased collection amidst the lockdown and credit installment deferral. Banks will confront pressures on liquidity from postponed premium gathering, and negative impacts on investment performance and capitalization from monetary market instability and lower interest rates [12]. The more people opted for loan moratoriums shows the high liquidity pressure created at present for the banks. This is shown in Figure 6.

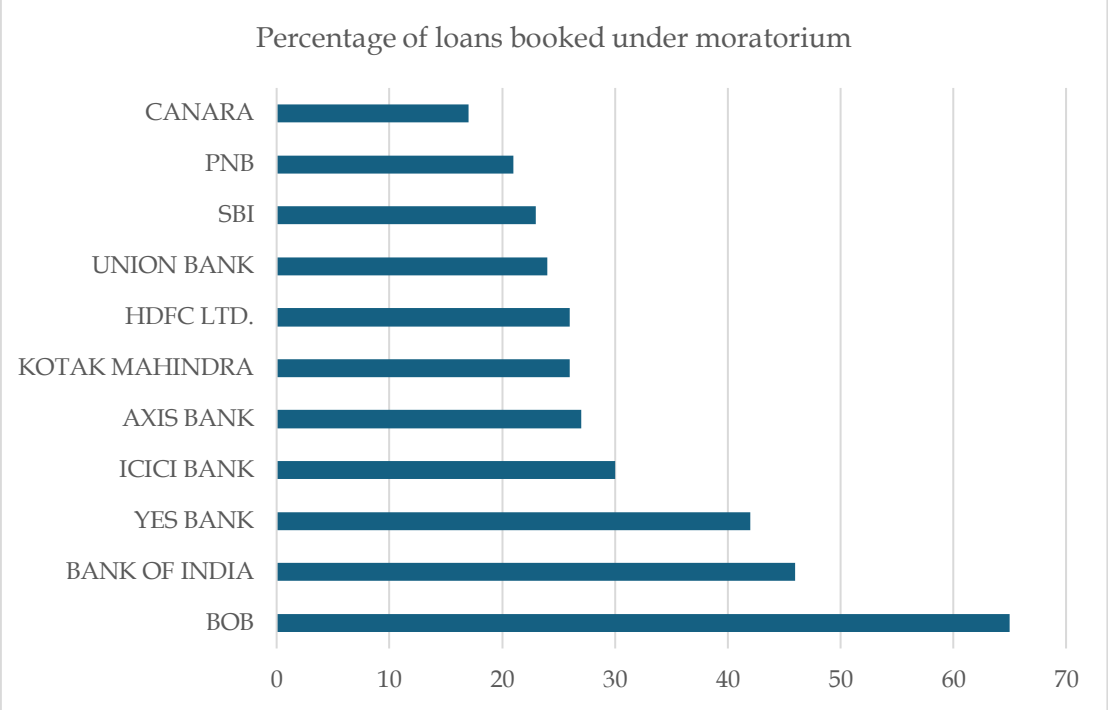

Figure 6: *Overall individual loans opted for a moratorium. Data source- RBI, financial stability report, Bloomberg quint.*

Source: https://www.bloombergquint.com/economy-finance/a-third-of-indias-bank-loans-may-remain-under-moratorium-till-august-end-says-macquaries-suresh-ganapathy

3.3. Lesser net interest margins due to lower policy rates

RBI chose to take an accommodative position and henceforth diminished the policy repo rate to resuscitate progress and relieve the effect of COVID-19. With this decision, Monetary Policy Committee (MPC) planned to keep inflation contained by the objective and subsequently to safeguard financial stability. The repo rate under the Liquidity Modification Office (LAF) has been decreased by 40 base points from 4.40% to 4.00%. This is the interest rate at which the RBI loans money to authorized commercial banks if they need momentary assistance to meet administrative or business necessities [10].

When the RBI cuts the repo rate, the expense of assets of banks diminishes. Subsequently, the banks can propel advances to their clients at a lower cost. Banks normally utilize the repo rate as a sign to decide their deposit rates, loaning rates, and base rates. The reverse repo rate under the LAF has decreased from 3.75% to 3.35%. Banks store their extra assets with the RBI. The rate at which RBI gives interest to Banks to deposit funds is known as the reverse repo rate. This rate is the rate at which the RBI gets cash from the banks, rather than loaning cash to them. A shrink in this may escalate the cash flows in the monetary market. When RBI decreases the reverse repo rate, banks get inclined to put their cash in different sources like loaning credits in the market. Along these lines, the income increments. Hence, a converse repo rate influences the liquidity of assets in the budgetary market.

The Marginal Standing Facility (MSF) rate and the Bank Rate have been decreased from 4.65% to 4.25%. Perseveringly low-interest rates disintegrate the net interest margins of banks (NIM). It indicates the distinction between the interests earned and paid by a bank compared to the interest-earning assets like cash. NIM quantifies the adequacy of an organization's investment choices. The interest rates on outstanding loans respond intensely to an alteration in the degree of transient market rates than interest rates on outstanding deposits [18]. These continuous lower interest rates will affect the Net Interest margin hence harming the profitability of the banks.

3.4. Low capital adequacy

Capital adequacy is the legal least reserves of capital that a bank or other monetary institution must have inaccessible reach. It is measured by Capital Adequacy Ratio (CAR) also called Capital to Risk (Weighted) Assets Ratio (CRAR). It is the proportion of a bank's cash flow to its risks. They are trailed to guarantee that banks can ingest a sensible amount of loss and conforms to legal Capital prerequisites. In the recent Financial Stability Report the capital adequacy ratio of banks framed down to 14.8 percent in March 2020, basically because of the decrease in CRARs [16]. Their Return on Assets kept on being negative as a gathering, however tepid credit development and moderate slippages could be seen. The framework level of Capital to Risk Asset Ratio is extended to fall from 14.6 percent in March 2020 to 13.3 percent in March 2021 under the regular situation and in case of an extreme economic pressure situation it will drop to 11.8 percent, this is shown in Figure 7. The outcome of the evaluation of the stress situation in banks demonstrates that few banks might neglect to fulfill the base capital requirement by March 2021 in an extremely serious stress situation. This, be that as it may, doesn't consider the mergers or any further recapitalization, which will additionally increment fundamental strength. The normal capital proportion has decreased from 11.7 percent in March 2020 to 10.7 percent under the benchmark situation and 9.4 percent under the extreme pressure situation in March 2021 in Figure 8.

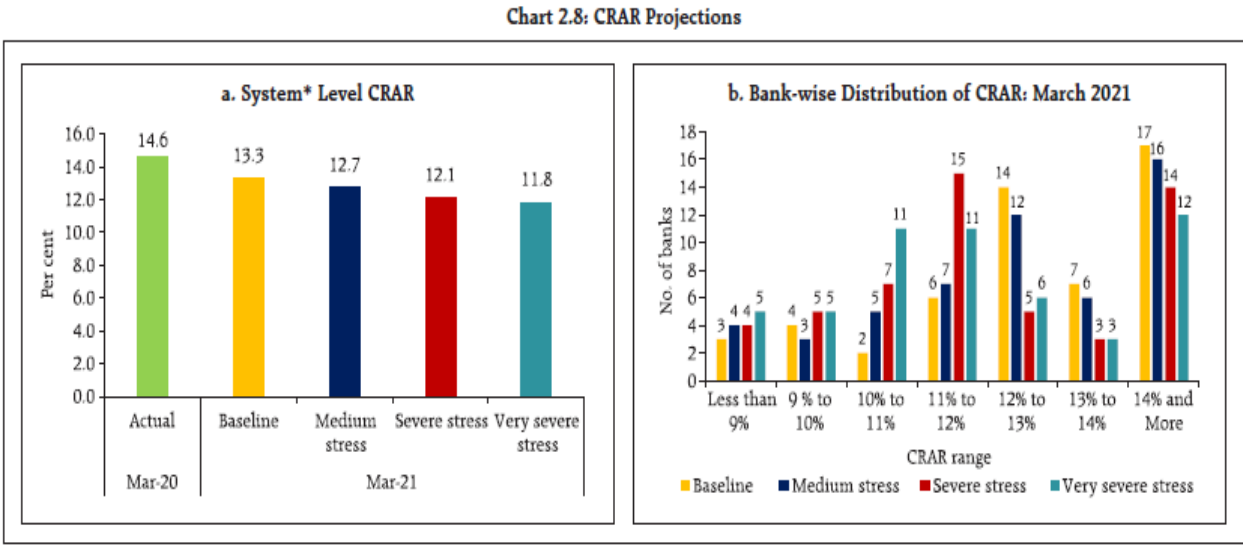

Figure 7: *Capital to risk asset ratio projections in baseline and stress scenarios. Data source-RBI, financial stability report (July 2020).*

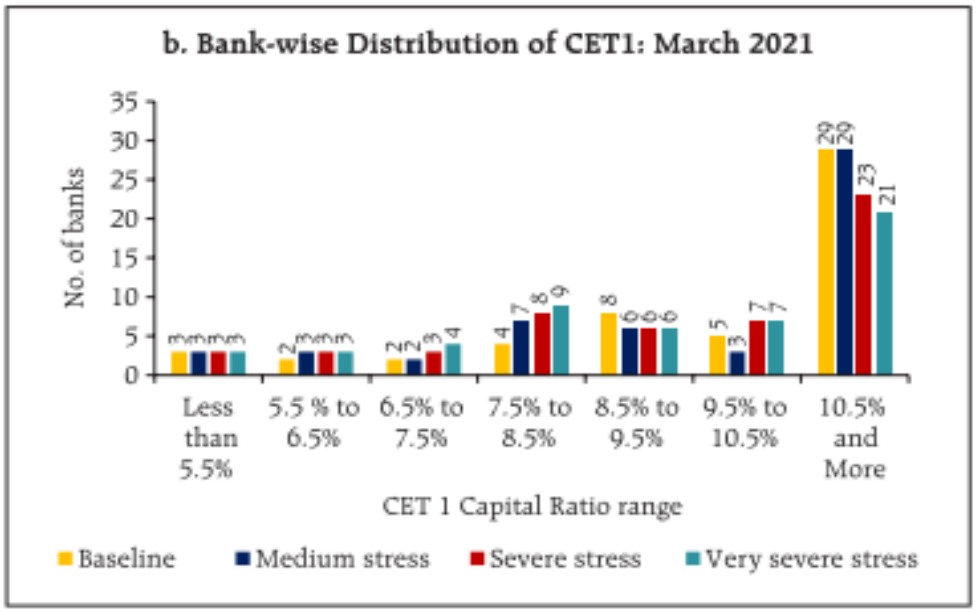

Figure 8: *Bank wise CRAR projection for march 2021. Data source-RBI, financial stability report (July 2020).*

3.5. Classification of non-performing assets

Across world covid -19 has increased the risk towards financial stability and India is not an exception to it. For COVID-affected borrowers and lending institutions, the six-month loan moratorium and one-time debt modification may have been a blessing to postpone the suffering. However, analysts have issued warnings about the potential accumulation of latent stress in the banking system as a result of these actions. When the moratorium period ended the Supreme court advised the banks not to proclaim these loans as non-performing assets and re-structuring will be done for the loan amount so that the financial stress on banks is managed in a better way. Due to a large restructuring of COVID-linked loans, Indian banks have faced a two-year period of extended uncertainty on the asset quality front.

Banks ease repayment requirements for stressed consumers as part of the restructuring without designating these loans as subprime. In reality, by posting FAQs and online tools on websites, banks have already started the process of implementing the COVID resolution solutions. The purpose is to aid borrowers in comprehending both their eligibility and the next steps they should undertake.

Before COVID-19 impact, the Indian banking sector had accumulated bad loans of approximately Rs 9 lakh crores. By the end of the 2020 fiscal year, the moratorium was anticipated to result in an increase in NPAs, and the RBI anticipated that the system level CRAR will decline to levels below that time last year. A protracted moratorium period could put extra strain on the banks' balance sheets, and the delayed recovery of the economy could reduce the interest income that banks get. In order to reduce the strain on their books and increase their capacity to lend, recapitalization played a very crucial role in fostering the bank resilience and working on maintaining NPAs within stipulated levels. The RBI figures 9 mentioned below also show that the asset quality of banks did not reduce during the covid years. Though there was some limit to the banks interest income during the covid years, banks managed their NPA levels due to following features: 1) A large portion of NPAs were written off to maintain a clean balance sheet 2) Debt Recovery Channels helped in resolving large NPA cases. 3) The covid related moratorium banks accounts were still to be identified as performing assets or non- performing assets.

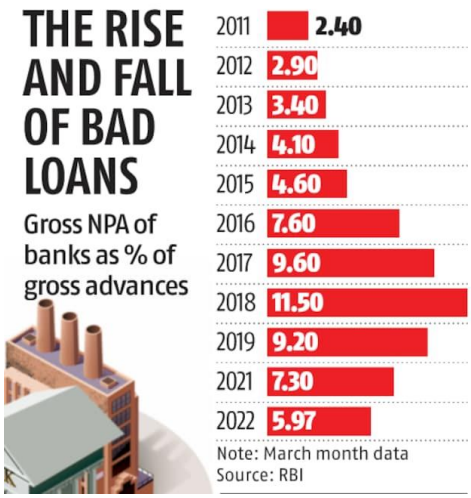

Figure 9: *The asset quality of banks did not reduce during the covid years.*

Source: https://www.business-standard.com/article/economy-policy/banking-sector-s-gross-npa-falls-below-6-lowest-in-six-years-122061601135_1.html

4. Discussion

The moratorium will affect the financial health of banks drastically by weakening the asset quality as the NPA level will rise because of the economic slowdown, there would be low capital adequacy, and the interest margins would be low hence banks will face low earnings. The liquidity pressure will also disturb the balance sheet of the banks highlighting the impaired assets. Loans and Non-performing loans (NPLs) of the banking industry will be influenced which will affect profit. Financial procedures to bring down the Statutory Reserve Requirements (SRR), overnight interest rates, and reclassification of non- recoverable loans will have a positive on Bank's income as banks will have more liquidity to meet the challenges.

The expense of assets and arrangements for NPLs won't have such an intense effect on banks' income. The credit organization measure in loan approval is significant as most advances are exposed to credit rules like single client limit, industry performance, and guarantee. The recuperation cycle of NPL may require some serious time. While reimbursement defers will give transitory help to borrowers, these mandates will likewise compel banks' capacities to take proactive reconstruction and restoration activities. These measures additionally could prompt a much more noteworthy development of credit losses once the moratorium is lifted. This danger will increment generously if the monetary slump, and measures to contain the spread of the Covid, endure for longer than expected.

5. Conclusion

The effect of the expansion of the moratorium will be distinctive for public and private segment banks. Public sector banks have been considerably more open to offering deferrals than private banks. As lockdowns are continuously eliminated, private segment banks will be considerably more proactive in their assortment endeavors, amplifying the distinction stance of public segment and private part banks. Therefore, public segment banks may wind up holding more remaining credit hazards, which will expose them to more asset quality dangers. India's private banks may need to put aside more money in loan loss provisions for an unanticipated disintegration in asset quality, burdening their income over the next quarters as the economy eases back because of the pandemic. However, the studies in past evaluated the influence of debt repayment on overall credit management of banks and the studies found that debt moratorium has not caused any moral hazard.

To curb these impacts, the government should provide clarity on the Covid curve, and inflation numbers as the financial health of banks and depositors depend heavily on these facts. The proper framework should be provided for the loan restructuring to sustain financial stability in the Indian banking sector. The moratorium was supposed to be a temporary solution, an extension of the same will hurt the bank hence the banks should examine the impact of debt performance on inclusive credit discipline. The previous section's findings specify that none of the debt moratorium options provided in our experiment earlier to the bank customers during their difficult times lead to any moral hazard in loan repayment. In fact, loan repayment improves when the lender is alleged as responsible for offering the forbearance and gets confidence on banks to continue future relationships.

6. Formatting of Funding Sources

This research did not receive any specific grant from funding agencies in the public, commercial, or not-for-profit sectors.

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